No. 11796

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CENTRAL INVESTMENT CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Review of the Decision of the Tax Court of the United States.

REPLY BRIEF FOR PETITIONER.

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TOPICAL INDEX

PAGE

TABLE OF AUTHORITIES CITED

Cases

Statutes, Regulations and Rulings

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REPLY BRIEF FOR PETITIONER.

Certain aspects of respondent's preliminary statements in his brief, including the Statement of the Question Presented, the Statement of the Case, and the Summary of Argument, are not wholly without objection. The objections thereto will all abundantly appear in our direct discussion of respondent's argument, however. We will therefore not discuss separately these portions of respondent's brief.

ANSWER TO RESPONDENT'S ARGUMENT.

1. Respondent's Basic Contention.

Before answering the specific arguments of respondent, it is important to observe that his entire case is based upon the proposition that the express provisions of the California Franchise Tax Act designating the date for the accrual of the tax and the attaching of the lien therefor have no effect for Federal tax purposes. (Br. 31 *et seq.*) However, under the form of presentation adopted by respondent, this is not made clear until after he has presented the principal part of his argument. (Br. 11-31.) Nevertheless, respondent's whole case must stand or fall on this proposition.

2. Respondent's Contention That a Double Deduction Is Involved Herein.

In footnote 10 (Br. 10), respondent refers to four decisions concerning double deductions, including two decisions by this Court. It is apparent from even a cursory reading of them, however, that they have absolutely no application to the problem here presented. They all relate to efforts by taxpayers to obtain a double tax benefit from the same expense or other deduction. Manifestly, the petitioner herein is not seeking a double deduction in the sense in which that term is used in the cited cases. Here, there is no question that the taxpayer is entitled to the deduction for both the franchise taxes, based on its 1942 and on its 1943 income. There is no effort to obtain the *same* deduction twice. It is simply a question of what year is the proper one in which to take certain deductions to which the taxpayer is admittedly entitled.

3. Respondent's Discussion of "The Accrual Doctrine in the Supreme Court and the Circuit Court of Appeals."

Respondent cites, as being "direct authority against taxpayer's position," twenty-one cases. (Br. 11-12.) Not one of them is directly in point. However, only the cases that respondent deems to be of sufficient importance to justify further discussion of their precise application to the issue herein will be considered in answering respondent's detailed argument.

Petitioner accepts *United States v. Anderson* (1926), 269 U. S. 422, as a leading case (see Br. 13) on the subject of accrual and deduction of taxes, but thinks it somewhat of an overstatement to say (Br. 16) that it is on all fours with the present case. To the extent to which it is applicable herein, it favors petitioner rather than respondent.

In the first place, it should be emphasized that in the *Anderson* case it was the taxpayer who was contending that the accrual of the tax did not occur until in the year in which it was assessed and became payable. The Supreme Court rejected this contention, however, upon the ground that the determination of the time for accrual should not be made in "any technical legal sense." It held that, in an economic sense, the tax had accrued in the preceding year in which the income was earned on which the tax was imposed.

Thus, from a practical standpoint the positions of the parties in the *Anderson* case are reversed in the present case. Here it is the petitioner that is contending that the tax accrued in the year in which the income was earned on which the tax is based, rather than in the later year in which the tax was assessed and became pay-

able. Of course, respondent will say that here the tax was "for" the latter year. On the other hand, petitioner asserts that if it is material at all to show that the tax is "attributable to" the year of accrual, this requirement is met here. This latter point will be discussed more fully hereinbelow.

It is submitted that all that the *Anderson* case held in regard to the time for accrual of taxes is that they must be accrued when, in an economic and bookkeeping sense, rather than in a technical legal sense, all of the events have occurred which fix the amount of the tax and determine the liability to pay it. It does *not,* as respondent contends (Br. 11), establish *two* principles governing the deduction of accrued taxes, viz., (1) that the tax must be imposed *for* the taxable year in which the deduction is taken, *and* (2) that all of the events giving rise to a fixed and definite liability must occur in the taxable year. Petitioner will consider each of these alleged requirements, in the order thus stated.

There is no requirement whatever that the tax be "for" the year in which deduction is taken. True, the Supreme Court, in the *Anderson* case, said that the purpose of the provisions of the Revenue Act there in question authorizing the use of the accrual method in computing net income was to enable taxpayers to keep their books and make their returns "by charging against income earned during the taxable period, the expenses incurred in and properly *attributable to the process of earning income* during that period * * *" (269 U. S. 422 at 440; emphasis added.) However, when it came to the point of deciding when the taxes on the income from munitions sales in 1916 *were properly accruable,* the Court considered only whether "liability" for

the tax had arisen in 1916. Thus, it in effect held that to the extent that general accrual principles require accrual of items in the year to which they are attributable, this requirement is satisfied in the case of tax charges by determining the year in which *liability* for the tax arose. The Court did *not* decide that, in addition to finding such "liability", the tax had to be *for* 1916.

True, the tax involved in the *Anderson* case *was* "for" 1916; but the Court did not make this a basis for its decision on the issue of when the tax accrued. That this must have been deliberate is evidenced by the fact that on other occasions the Supreme Court has held that taxes accrue when liability therefor arises without regard to whether they are "for" the period in which such liability arises. (*Magruder v. Supplee* (1942), 316 U. S. 394, 62 S. Ct. 1162, 86 L. Ed. 1555.) The *Anderson* and *Supplee* cases contain no element of inconsistency if the former is recognized as holding, simply, that taxes accrue in and are attributable to the year in which liability therefor arises.

It is further submitted, however, that even if the *Anderson* case does impose some requirement over and above the requirement that liability be established in the year of accrual, such additional requirement is not as stated by respondent. For the precise language of the *Anderson* case in regard to the accrual of liabilities generally is that such method of accounting was designed to enable taxpayers to charge against income earned during a given period the expenses incurred "and properly attributable to the process of earning income during that period." Respondent has transposed this into the statement that the tax must be *for* the year in which is is accrued. It is submitted that this transposition is both important and unjustified. For, if the language thus used by the Su-

preme Court is applied in a realistic manner rather than in a technical legal sense, it is clear that the California franchise tax is "attributable to the process of earning income" during the "income" year, even though it may not be "for" that year in the sense in which respondent uses the latter term.

Thus, the historical background of the California franchise tax discloses beyond doubt that the *only* reason for imposing the tax as a tax for the privilege of doing business, with the amount of the tax *measured by* net income, instead of imposing a tax directly *upon* net income, was to enable the State to conform its scheme of taxation of corporations to a permitted method of taxing banks without discrimination against the latter but with the inclusion of the income from tax exempt securities in the base for the tax. (*Pacific Company v. Johnson* (1931), 285 U. S. 480, 491-492.) In a business and economic sense, however, the *burden* of the tax is precisely the same as though it were a tax *on* income, as in the *Anderson* case. The tax based upon the income of the "income year" is required to be paid regardless of whether there is any income at all from the operation of the business during the privilege year. The tax based upon the income of the "income year" is required to be paid in full regardless of whether the corporation has a "taxable year" of twelve months or of less duration. [Act, Section 13 (o), Op. Br. Appendix 13.] In an economic and business sense, then, it is clear that the tax is attributable to and a charge upon the income upon which it was based.

This view is directly confirmed by the manner in which Section 403(a)(4)(B) of the Renegotiation Act (Act of April 28, 1942, P. L. 528, 77th Cong., as amended by Section 701(b) of the Revenue Act of 1943) and the

regulations thereunder require taxes such as the California franchise tax to be taken into account. The application of this provision to state "income taxes" is stated in the Renegotiation Regulations as set forth in the footnote.[1]

[1]389. *State Income Taxes.*

389.1. *In General.* Under subsection (a) (4) (B) of the 1943 Act, taxes measured by income cannot be allowed as items of cost for purposes of renegotiation. However, this subsection provided specifically that in determining the amount of excessive profits to be eliminated, proper adjustment shall be made on account of the taxes measured by income (other than Federal taxes) so excluded, *which are attributable to* non-excessive renegotiable profits. The amount of any such adjustment will in no case exceed that part of such taxes actually payable which is payable because of the inclusion in income of the non-excessive renegotiable profits. The term "taxes measured by income" is interpreted to mean taxes which vary in accordance with the amount of net income of the taxpayer. Such term does not include taxes imposed upon or measured by gross income, gross receipts or sales. Such taxes measured by net income are herein referred to generally as "state income taxes" although actually they may not be designated as "income taxes" in the legislation imposing such taxes, and although they may be imposed by political subdivisions other than a state. * * *

* * * * * * * *

389.5. *State Income Tax Measured by Income for Preceding Year.* In some states, the tax is measured by the income for the year subject to renegotiation but is a liability of the contractor not for such year but for the next succeeding year. *In this event, the adjustment for such tax will be made as though such tax measured by the income subject to renegotiation were in fact a liability for the year subject to renegotiation.* (Emphasis added.)

Therefore, although the tax may be "for" the privilege year, it is, in the language of the *Anderson* case, only in a "technical legal sense", if at all, that the tax is "attributable to" the privilege year. Further, in the language of that case, in an economic sense a taxpayer's true income for the income year could not have been determined without deducting from its gross income for the year the franchise tax based upon the production of that income.

Notwithstanding the true economic situation was as thus stated, the tax statute, prior to the 1943 amendments, expressly provided that the tax accrued and became a lien on the first day of the "taxable year." On the face of the statute, then, all taxpayers were seemingly "tied" to an accrual and deduction of the tax according to its technical legal aspects rather than according to its real economic burden. And this is the view taken by the Commissioner in his rulings under the earlier statute. Accordingly, the Act was amended in 1943 to establish the accrual and lien date as the last day of the income year rather than the first day of the taxable year, in order to conform the technical accrual with the economic realities.

Thus, even if it were to be assumed that a purely arbitrary accrual and lien date in advance of the period "for" which the tax was imposed would not be controlling for Federal income tax purposes—an assumption which is directly opposed to the decisions giving effect to the arbitrary lien date in property tax cases—it is clear that in the present case the California Legislature has *not* arbitrarily or capriciously selected an accrual and lien date. Rather, it has abandoned a date which had significance in a technical legal sense only, in favor of a date which makes the establishment of liability for the tax conform to the economic realities in regard to the burden of the tax. There is nothing in the *Anderson* case or in any other case that would support the Commissioner in disregarding such a provision of the controlling local law.

It is submitted, then, that if the requirement of the *Anderson* case that the tax be attributable to the earning of the income in the year in which accrual of the tax is claimed calls for something *more* than proof that "lia-

bility" for the tax arose in such year, such "additional" requirement is abundantly met in the present case.

But what of the "second" principle of the *Anderson* case, viz., that all of the events giving rise to liability must have occurred during the tax year? Petitioner does not dispute that this "liability" factor is a basic requirement; in fact, it asserts that it is *the* basic requirement. The essential difference between respondent and petitioner relates to the proper interpretation or true meaning of this legal principle.

In the first place, although in stating this requirement it is sometimes said that in order to render a tax accruable in a given year "all of the events must occur in that year which fix the amount and the fact of the taxpayer's liability" (*Dixie Pine Products Co. v. Commissioner* (1944), 320 U. S. 516, 64 S. Ct. 364, 88 L. Ed. 270), it has never been considered that absolute certainty is necessary as to the amount which may ultimately be *paid*. All that is required is that the amount and fact of the *liability* be established. This is consistent with the general rules in regard to the accrual of contingent liabilities.

Respondent states (Br. 11) that a "contingent" liability will not satisfy the requirement that all of the events giving rise to liability must have occurred during the tax year in which the accrual of the tax is claimed. He does not favor the Court with any discussion of the effect of this proposition as applied to the facts herein. It is apparent, however, that respondent's conclusion that petitioner's liability for the franchise tax based on its 1943 net income was contingent on December 31, 1943, is the result of his fundamental error in disregarding the express provisions of the Act imposing liability on that date,

and of his failure to recognize the principle distinguishing between contingencies which go to the existence of liability, and contingencies which affect the amount which may ultimately have to be *paid* on account of the liability. (See *Helvering v. Russion Finance & Construction Co.* (C. C. A. 2, 1935), 77 F. (2d) 234.) None of the cases cited by respondent which relate to the question of contingent liabilities establish any different principles than those stated and discussed in Petitioner's Opening Brief (p. 33 *et seq.*).

A further difference between respondent and petitioner is in determining what *are* "the events" which determine the liability of the taxpayer for the California franchise tax.

It is respondent's position that there is and can be no liability for the franchise tax except as the privilege is exercised "for" which the tax is imposed, and that the doing of business in the "taxable year" is, therefore, "the event" which gives rise to liability. (Br. 12-13.) He repeats this erroneous assertion upon numerous occasions throughout his brief. Manifestly, this proposition is of fundamental importance to respondent's case.

There are two answers to respondent's statement as made at pages 12-13 of his brief. First, it is not true that there would be *no* tax if the taxpayer did no business in 1944. Secondly, the mere fact that subsequent events might make it possible for the taxpayer to obtain an abatement of part *or even all* of the tax for which the statute imposes liability as of the last day of the year on the income on which it is based, does not justify the conclusion that there "is no liability" on the date specified. Each of these answers will be separately considered.

In support of the statement that "if the taxpayer did no business in 1944 there would be no tax," respondent refers (Br. 13) to page 29 of the Transcript of Record. This is the testimony of one Harry R. Freese, a minor state employee. [R. 21.] The statement of the witness is merely his interpretation of the effect of the Act. [See R. 23.] Furthermore, from a reading of the entire testimony of this witness on the subject, it is evident that he was considerably confused by the questions. [See R. 29-30.] And even if this were not so, the fact would remain that it simply is not the law that a corporation is not required to pay any tax under the Bank and Corporation Franchise Tax Act merely because it does no business during the first fifteen days of the "taxable year." (See Op. Br. 32-33 and Appendix thereto, 4, 11-12.)

For the Franchise Tax Commissioner's official interpretation in this regard see Regulation Article 29-1, Paragraph 2, Cal. C.T. Paragraph 8-053. (Op. Br. Appendix, p. 18.) Respondent's constant repetition of his proposition that there would be no liability if no business done in the taxable year does not change the law.

It should also be noted that in his argument respondent speaks solely in terms of the effect of not doing any "business" in the taxable year. The only provisions in the Act for any abatement or refund, however, relate to a dissolution (of a domestic corporation) or withdrawal (of a foreign corporation). Thus it is clearly not simply a matter of not doing any business. Nor, in fact, is it even a mere matter of dissolving. For if the dissolution does not completely terminate the conduct of the business by *any* corporation under the "control" (80% of stock) of the same stockholders, the tax liability of the dissolved

corporation will be carried over to the successor corporation. (Act, Sec. 13(j) and (k), Op. Br. Appendix 10-11.) Compare Act. Sec. 13(1) (Op. Br. Appendix 12).

Even if it were true, however, that petitioner could have obtained an abatement or refund of the *entire* tax based on its 1943 income *if* it "did no business" in 1944, it would not follow that there was no "liability" on December 31, 1943. Manifestly, there can be an existing "liability" for a tax even though it is one which may never have to be *satisfied* because of events that may occur after the liability has been established. This is a point which was fully developed by petitioner in its Opening Brief (pp. 33-45; see also *Fawcus Machine Company v. United States* (1931), 282 U. S. 375. It is unmistakably provided in the tax statute here in question that liability for the tax *shall* arise (accrue) on the last day of the year on the income of which the tax is based. In other words, under the statute "the events" establishing liability are the earning of net income in the "income year" and the failure to dissolve in the requisite manner by the last day of that year. Manifestly, any contingencies based on subsequent events relate merely to the amount which may have to be *paid* in order to *discharge* the liability and the lien therefor; they have no relation whatsoever to the establishment of "liability" in the first place.

Hence, in order to say that there was no "liability" on December 31, 1943, for the tax based on petitioner's 1943 net income, it would be necessary to hold that it was beyond the power of the California Legislature to impose statutory liability on that date. Even respondent has not attempted to show that this is true.

Certainly the legislative body which has the power to impose the tax has power to say when liability for such

tax shall arise. The California Legislature has in unmistakable terms identified precisely the time when liability for the California franchise tax arises. The respondent, however, chooses to ignore these explicit provisions in favor of a determination by a reference solely to other provisions of the statute. There is no authority which supports this disregard of the statute imposing the tax liability the accrual of which is in question.

Respondent presents several asserted reasons for disregarding the *lien* in the present case as a factor in identifying the time when liability for the tax arises. First, he suggests (Br. p. 15) that in the *Anderson* case itself the Court ignored a lien because it was "not even worthy of the 'technical legal' characterization given to the assessment date in the Anderson opinion * * *." This is refuted, however, by the fact that the Supreme Court itself, in *Magruder v. Supplee* (1942), 316 U. S. 394, recognized the establishment of a lien for a tax as an identification of the time when liability for the tax must have arisen. See also *Crown-Zellerbach Corp.*, 43 B. T. A. 541 at 544. Furthermore, the lien provision referred to by respondent (Br. 15), by its very terms, applies only when a person is liable to pay any tax and neglects and refuses to pay the same *after demand.* In such event, it is provided that the amount shall be a lien *from the time the tax was due* until paid. Manifestly, this would not be such a lien as would have changed the result of the *Anderson* case, for the Court there held that the tax accrued at an *earlier* date than the "due" date. Under this view, the *Anderson* case would be an example of the principle, stated in Petitioner's Opening Brief (p. 30), that even if the statute contains a lien provision, it is still proper to determine, from a consideration of all of the provisions of the tax statute, that liability arises at an

earlier date than the lien date. See *S. E. Bernheimer,* 41 B. T. A. 249, 252, affirmed by the Circuit Court of Appeals for the Second Circuit, in a *per curiam* opinion. on the authority, in part of the *Anderson* case. (121 F. (2d) 454.)

In the present case, however, respondent would have this Court disregard the lien in favor of a *later* accrual date. There is nothing in the *Anderson* case—or in any other case of which petitioner is aware—which would justify this result.

Respondent also seeks to avoid the effect of the lien provisions of the Franchise Tax Act by asserting that this lien is not valid in any event. (Br. 20.) If the lien imposed by the Franchise Tax Act is invalid because, as respondent suggests (p. 20), it precedes the other steps in assessing and collecting the tax, then all of the tax liens in the State of California are likewise invalid. It is surprising that this has not been discovered before. (Cf. authorities at Op. Br. 26.) Furthermore, the Legislature has removed any doubt as to there being a liability at the date the lien attaches by expressly providing that the tax shall accrue on that day. Manifestly, the Legislature has gone as far as any legislature conceivably could to remove any question as to when it intended liability for the tax to arise. Yet the respondent persists, repeatedly, in asserting that there *wasn't* any liability on the last day of the income year.

Respondent states (Br. 20):

> But even if the lien were valid it does not mark the accrual date under federal law because California often imposes liens for taxes before all the events occur which fix the fact and amount of liability—and the latter and not the lien dates, we again, emphasize, are the tests of accrual.

But it has never been held that any such lien is for that reason to be disregarded in favor of a later accrual date. (See *Crown-Zellerbach Corp., supra.*) Manifestly, the reason is the universal acceptance of the fundamental principle that where there is a valid lien there must be liability, and when "the events" have occurred which establish liability under the statute then "the events" have occurred to support an accrual of the liability.

Respondent's discussion at pages 20 to 21 misinterprets the decisions of this Court in *United States v. Sampsell, supra,* and *In re Knox-Powell-Stockton,* 100 F. (2d) 979. These cases were correctly cited and analyzed in Petitioner's Opening Brief (pp. 13 *et seq.*). If the lien is valid so as to be entitled to recognition in a bankruptcy proceeding, there must necessarily have been a "liability" to support it. (*East Bay Municipal Utility District v. Garrison,* 191 Cal. 680, 692-693. See also *Magruder v. Supplee,* 316 U. S. 394, at 397.)

Respondent contends (Br. 18-19) that it would violate Section 43 of the Internal Revenue Code to permit a deduction in 1943 for the tax based on 1943 income as well as on 1942 income. This is not true. As is said in *Dixie Pine Products Co. v. Commissioner* (1944), 320 U. S. 516, at 519,

> * * * It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which *really accrues* in the taxable year. (Emphasis added.)

Section 43 of the Internal Revenue Code does not in any way limit this statement. If there are in fact two tax liabilities *imposed* in a single year, the taxpayer is entitled to deduct them both. The Commissioner has in ef-

fect himself recognized this in his rulings in regard to the accrual of franchise taxes imposed by other states. (See I. T. 3846 ~~3151~~, 1947-1 C. B. 17, in effect allowing the deduction of two Tennessee franchise taxes in a single year where there was a change in accrual date as a result of a new *interpretation* of the state law.)

Respondent says (Br. 18-19) that the imposition of liability for two taxes in 1943 is "not to be distinguished from liability for interest or rent for a period of years * * *," which is within the scope of Section 43. It seems to petitioner that there is a substantial difference between the two situations. Each tax is admittedly a separate tax separately imposed, rather than being a single payment for several years, as in the case of the rent. The situation is more comparable to that which existed when the liability for personal income taxes under the Internal Revenue Code was placed on a current basis. The only difference is that the United States forgave part of the tax upon 1942 income, whereas the State of California did not forgive any tax but put the liability of corporations for franchise taxes on a current basis. The fact that there thus resulted two tax liabilities in one year is clearly not the type of situation covered by Section 43. (See *Security Flour Mills Co. v. Commissioner* (1944), 321 U. S. 281.)

4. Respondent's Argument That "The Tax Court Decisions Do Not Support the Taxpayer."

Under a separate heading captioned "The Tax Court decisions do not support the taxpayer" respondent states (Br. 22):

> Counsel's approach to this case in general is to ignore the controlling decisions of the Supreme Court and the Circuit Courts of Appeals, with the exceptions which we have noted and others that have no bearing on the issue. This is perhaps understandable in view of the fact that they could find no support from those quarters. What is surprising is that they rely largely on decisions of the Tax Court.

Petitioner cited and discussed, in what appeared to it to be the appropriate setting, not only the leading Supreme Court cases—*Magruder v. Supplee* and *United States v. Anderson*[2]—but numerous other decisions. It is believed that the decisions cited and discussed by petitioner will afford an ample basis for a decision herein.

Some of the Board of Tax Appeals decisions cited and discussed by petitioner in its Opening Brief, very clearly were referred to for the sole purpose of showing that they were *not* controlling notwithstanding that they were relied upon by the Tax Court in support of its decision in the present case. (Op. Br. 47-54.) Yet respondent refers (Br. 22-25) to these cases as being cited by and "relied on" by petitioner—and he proceeds to discuss them on this basis. This portion of respondent's discussion is therefore clearly irrelevant, and needs no further answer.

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[2]The Supreme Court decisions in *Security Flour Mills Co. v. Commissioner* (1944), 321 U. S. 281, and *Dixie Pine Products Co. v. Commissioner* (1944), 320 U. S. 516, are also considered under appropriate headings.

Although criticizing petitioner for referring to Tax Court decisions that have become final, respondent deems it important to make the point that "the entire Tax Court is convinced of the correctness of the result" in the present case, even though it is now pending on review. (Br. 22.) It is not apparent how this would remotely support the conclusion reached by respondent, even if it were true—as certainly does not appear from any of the assertions made by respondent in support thereof.

5. The Commissioner's Administrative Practice.

The respondent asserts (Br. 26) that his ruling in I. T. 3646, 1944-1 C. B. 104, relating to the accrual of the California franchise tax, was "consistent with earlier ones dealing with previous versions of the California tax" and also was "consistent with the treatment accorded other state franchise taxes." There are two answers to these assertions. First, they are not wholly accurate. Second, they are immaterial in any event.

Respondent's present interpretation of I. T. 3646 (Br. 16) is that "the tax liability arose monthly at the rate of one-twelfth of the tax measured by 1943 income * * *." This position is necessitated by his insistence that the provisions of the Act relating to the effect of dissolution during the "taxable year" are conditions precedent to liability, although the Act clearly shows that liability arose on the last day of the income year and that, at most, this liability is subject to partial abatement or refund if the corporation dissolves in the requisite manner during the "taxable year." This same position was *not* taken in I. T. 3646, however. There, it was ruled that under the 1943 Amendments, the California franchise tax does not accrue on the last day of a

taxpayer corporation's "income year," *but on the first day of the corporation's "taxable year."*

The earlier rulings relating to the accrual of the California franchise tax were also to the effect that the tax accrued on the *first day* after the close of the year on the income of which the tax was based.[3] (I. T. 2971, XV-1 C. B. 111 (1934); I. T. 2988, XV-2 C. B. 179 (1936).) This was strictly in conformity with the accrual date as then specified in the California statute. It was only in I. T. 3646 that the Commissioner departed from the accrual date specified in the statute. But he did not even then conclude, as he now contends, that liability for the tax accrued monthly during the taxable year.

Presumably his present abandonment of his earlier position was necessitated by the inconsistency in which it placed him in contending that the liability was contingent on the last day of the income year but was not contingent on the first day of the taxable year. Certainly, if "all of the events" fixing liability have not occurred on December 31, neither have they on January 1. But petitioner is not aware of any decision which has as yet *required* a taxpayer to accrue on a monthly basis. At most, this has been *permitted* when it is in accordance with the regular practice of the taxpayer and usually over the *objection* of the Commissioner. Petitioner, however, has regularly accrued its taxes in accordance with the accrual date specified in the local law.

Also, in regard to the asserted "consistency" of the Commissioner's position herein, or in I. T. 3646, with the treatment accorded other state franchise taxes, it

[3]The references to "income year" and to "taxable year" have not always been the same. (See Op. Br. p. 4, Note 3.)

should be noted that so far as appears from the rulings themselves the Commissioner has *never* previously been confronted with a statute which contained an express accrual and lien provision which he disregarded in favor of a later accrual date. Manifestly, neither the earlier rulings on the California franchise tax nor the rulings on other state franchise taxes, even if constituting "authority," establish any precedent which fits the situation under the 1943 amendments to the California Franchise Tax Act. (See Op. Br. 23.)

Secondly, however, it is elementary that rulings of the Commissioner are not "authority" no matter how consistent they may be. (*Cole v. Commissioner* (C. C. A. 9, 1934), 81 F. (2d) 485, 487-8.)

As a part of his discussion of the discretionary powers of the Commissioner with respect to accrual, respondent states that petitioner's accrual in 1943 of the tax based on 1943 income does not "properly reflect" income. Respondent says (Br. 27-8):

> * * * Section 41 delegates to the Commissioner unusual authority to determine when an item is properly accruable. The standard is proper reflection of income "in the opinion of the Commissioner." The exercise of this discretion is only reviewable when it is clearly abused.

But no case to which respondent refers, and none of which petitioner is aware, holds that the Commissioner is vested with discretion to disregard the express provisions of a state tax statute as to when liability shall accrue and a lien attach, in favor of a later accrual date. If the statutory provisions are not controlling, then it is not necessary for the Commissioner to rely on any "discretion" vested in him. If the statutory provisions are controlling,

then a disregard thereof is a clear abuse of the discretion that is vested in the Commissioner. The provisions of section 41 clearly were not intended to authorize the Commissioner to change the year in which an item *really accrues.* (*Cf. Security Flour Mills Co. v. Commissioner, supra.* And see *Dixie Pine Products Co. v. Commissioner,* 320 U. S. 516, 519.)

6. Respondent's Discussion of "The Property Tax Cases."

Respondent states (Br. 29) that:

> The taxpayer places substantial, if not, principal reliance on the alleged rule that real property taxes are accrued on the lien date.

What petitioner in fact stated was that the controlling principle is that taxes "accrue" for Federal income tax purposes in the Federal taxable year in which falls the date on which personal liability for the tax arises *or* in which a lien therefor attaches, whichever is earlier. It was in support of these statements that petitioner cited *Magruder v. Supplee* (1942), 316 U. S. 394, *supra; California Sanitary Co., Ltd.* (1935), 35 B. T. A. 122, and *Crown-Zellerbach Corp.* (1941), 43 B. T. A. 541, *supra.*

Respondent seeks to distinguish the first two of these cases upon the ground that they involved only the question of "who is the taxpayer, not when does the tax accrue." (Br. 29.) It would seem elementary that if it has been determined, as in the cited cases, that there was a tax charge upon property at the lien date, for purposes of ascertaining who is entitled to a tax deduction for a payment of the tax—*i.e.,* the person who owned the property on the lien date or the person who subsequently purchased the property—it must necessarily have been determined that there was *a tax liability* on the lien date.

Otherwise, it is not apparent how there could be any tax which can be said to be the liability of the owner as of that date.

Even if there were any room for doubt upon this as a matter of abstract reason, however, it is completely answered by a careful reading of the opinion in the *Supplee* case. See, also, *Lifson v. Commissioner* (C. C. A. 8, 1938), 98 F. (2d) 508, so interpreting the *Supplee* case.

The cases cited by respondent (Br. 29-30)[4] are not in point. Their distinction of the *Supplee* case is, at most, applicable where the taxpayer has regularly employed the monthly accrual method in keeping its books. Certainly, a decision that a taxpayer *may* accrue taxes monthly does not support the conclusion that all taxpayers are *required* to accrue taxes monthly. See *Atlantic Coast Line R. Co.*, 4 T. C. 140; and compare *Budd International Corp.,* 45 B. T. A. 737, reversed on other grounds, C. C. A. 3, 1944, 143 F. (2d) 784. In the present case, the uniform practice of the petitioner was to accrue liability for the franchise tax on the single lien and accrual date specified in the tax statute.

The respondent states (Br. 30) that *Crown-Zellerbach Corp., supra,* reached a result contrary to that reached in the *Atlanta Stove Works,* and *Schock, Gusmer & Co.* cases. Petitioner does not agree. The decisions cited by respondent merely state an exception to the general rule which is correctly stated and applied in the *Crown-Zellerbach* case, which *exception* is wholly inapplicable in the present case.

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[4]*Allen v. Atlanta Stove Works* (C. C. A. 5, 1943), 138 F. (2d) 452, and *Commissioner v. Schock, Gusmer & Co.* (C. C. A. 3, 1943), 137 F. (2d) 750.

Nor is *Crown-Zellerbach* "repudiated," as respondent suggests (Br. 30) by the decision in *S. E. and M. E. Bernheimer Co., supra.* As has previously been noted, the *Bernheimer* case merely holds that a tax *may* accrue *prior* to the lien date if the other provisions of the tax statute show that liability in fact arose at such earlier date. However, that case is no authority whatsoever for the proposition—contended for herein by the respondent—that the Commissioner may require the accrual of a tax at a date *later* than the date specified in the tax statute for the accrual of liability for the tax and for the attaching of a lien. As a matter of fact, in affirming, *per curiam,* the *Bernheimer* case, *supra,* the Circuit Court of Appeals for the Second Circuit does so on the authority, in part, of *United States v. Anderson, supra.* Apparently, then, that Court didn't think there was a different rule for property taxes than for income taxes.

As a final ground for distinguishing the property tax cases—holding that taxes accrue when there is personal liability or a lien therefor, whichever is earlier—respondent asserts (Br. 30-31) that these cases are not controlling because, according to the Supreme Court in the *Supplee* case, it is misleading to speak of real estate taxes as "applicable" to the fractional part of a tax year, whereas "the California franchise tax is expressly imposed for the privilege of doing business year by year and even month by month." In other words, respondent in effect contends that the cases involving property taxes are *per se* inapplicable. There are several answers to this contention.

In the first place, respondent himself has not consistently considered the principles of cases involving the accrual of property taxes to be *per se* inapplicable in determining the proper time of accrual of the tax involved herein. On the contrary, he cites numerous property tax cases as being

"direct authority against taxpayer's position" herein. (Br. 12.) Secondly, the dictum in the *Supplee* case which respondent quotes (Br. 30) in regard to property taxes not being "applicable" to the fractional part of a tax period is disapproved in the decision in *Commissioner v. Schock, Gusmer & Co., supra*, cited by respondent. As that case points out, annually recurring property taxes are a very real part of the continuing overhead expense of a business. In this they are not essentially different from a franchise tax. In any event, however, as is more fully developed elsewhere herein, the California franchise tax is, from the standpoint of the taxpayer, a payment for the privilege of doing business in the taxable year in a "technical legal sense" only. In a substantial and economic sense it is a charge upon the income which is the basis for the tax. The purported distinction of property tax cases upon the ground that the tax in the present case is for the privilege of doing business "year by year and even month by month" is without merit. So are property taxes a part of the overhead cost of doing business year by year and even month by month.

Also, in support of his contention that the "property tax cases" are inapplicable herein, respondent says that "When a lien attaches for realty taxes a liability exists and the tax cannot be defeated." (Br. 31.) This is not wholly true. If, as in California, the lien attaches prior to any of the other proceedings for the assessment or collection of the tax, there is considerably less certainty in regard to both the existence and amount of the liability than there was in regard to both the existence and amount of petitioner's liability on December 31, 1943, for the franchise tax based on its 1943 income. If the lien precedes the other steps in the assessment and collection of the tax, there is no certainty at all as to the amount of

the property taxes. The levy may be large or small, or, as is judicially recognized in *Allen v. Atlanta Stove Works, supra,* may be omitted entirely. Or certain property may subsequently be freed of any liability for the tax. This has actually occurred in California, even though here it was necessary to amend the State Constitution to do so. (See Calif. Const., Art. XIII, Sec. 8a.) In states which do not have a constitutional prohibition against gifts of public funds, such as was deemed to require the above-mentioned constitutional amendment in California, the property tax could be abated, and the lien thus removed, by simple legislative action. (See Op. Br. 33 *et seq.*)

Manifestly, the fact that there are many contingencies which may affect the amount which may ultimately have to be paid on the tax does not justify the conclusion that there *isn't* "liability" until all of those contingencies have been eliminated. The imposition of a statutory lien for *any* tax, whether property tax or franchise tax or other tax, as of a specified date, is simply one way for the legislative body to say to the taxpayer, Now and henceforth you *are liable,* even though the amount you will be required to pay on this liability may be reduced or even entirely abated by certain subsequent events.

7. Respondent's Consideration of the Accrual and Lien Provisions of the California Franchise Tax Act.

Having devoted the principal portion of his brief to a discussion of what he considers to be the established rules of when to accrue a liability for Federal tax purposes, in complete disregard of the accrual and lien provisions of the California Franchise Tax Act, respondent, after a very brief discussion, brushes aside these provisions of

the local law as being not controlling for Federal tax purposes. (Resp. Br. 31-34.) He attempts to justify this upon the ground that Federal revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation, uniform in its application. (Br. 31.) In support of this proposition he cites (Br. 32) various cases which do not involve the accrual of liability for taxes imposed by local law. Their inapplicability is so self-evident as not to warrant any separate discussion of them.[5]

As pointed out in Petitioner's Opening Brief (p. 21) it is expressly declared by Randolph Paul in his Selected Studies in Federal Taxation, Second Series, page 23, that the Federal statute does, by "necessary implication," make the state law controlling in regard to when a tax is accrued as well as in regard to what is a state tax and who is liable. The Supreme Court of the United States, in *Magruder v. Supplee, supra,* cited this statement by Paul in support of the proposition that "Resort must be had here to the laws of Maryland and the city of Baltimore to determine upon whom the state and city real estate taxes were imposed." (316 U. S. 394, at 396.)

Respondent apparently is conscious, however, of the importance to his case of disregarding completely the ex-

[5]*Estate of Putnam v. Commissioner*, 312 U. S. 399, cited by respondent (Br. p. 32), involved the word "accrued" as used in Section 42. Even the most cursory examination of the decisions applying Section 42 will satisfy that the word "accrued," as used in that section, has a special meaning vastly different from the general definition of "accrued" in Section 48, and that the nature of the mischief which Congress sought to remedy when in 1934 it added the last sentence of Section 42, required that the meaning of "accrued"—"in this section," as the Court was careful to say—be uniform. See *Helvering v. Enright's Estate,* 312 U. S. 636, for a statement of the purpose of Congress in the 1934 amendment to Section 42.

press provisions of the local law as to when liability arises and the lien attaches. It is evident that it is only upon this basic assumption, upon which substantially his entire argument rests, that he can possibly reach the conclusions stated in the earlier portions of his brief.

Respondent refers to *George S. Colton Elastic Web Co. v. United States,* 116 F. (2d) 202, in support of the proposition that state law is not controlling in regard to the time of accrual of local taxes. That case did at least involve the question of the accrual of a state tax. However, the state statute there involved was not clear in specifying whether the excise tax thereby imposed was a "single tax" made up of the sum of two factors, one applied to income and the other to "corporate excess," or whether it imposed a separate tax with respect to each factor. The Supreme Judicial Court of Massachusetts had interpreted the statute as providing for a single tax, in upholding the constitutionality thereof. The Circuit Court of Appeals in the cited case, however, determined the accrual date of the tax for Federal income tax purposes in accordance with its own interpretation of the state statute. It did this, not because it considered the local law to be ineffective, but because it considered that the time of accrual of liability under the local law was not to be determined according to the characterization of the statute for purposes of determining its constitutionality. It is clear that even the court which decided the cited case would not have disregarded a clear and unequivocal provision in the local statute identifying the time when liability for the tax arises and the lien attaches.

In declining to follow the characterization, by the Massachusetts Supreme Judicial Court, of the tax as a single

excise tax, the Circuit Court of Appeals stated (116 F. (2d) at 204):

> We do not think this language is determinative of the issue in the case at bar. Certainly the characterization of the excise as "single", apparently directed to the queston of constitutionality, is not conclusive upon us in determining how the Massachusetts tax is to be treated for federal income tax purposes. However, as an interpretation of the Massachusetts statute involved, and as an indication of the liabilities of corporate taxpayers under that act, the Springdale decision is of course binding upon us.

The case thus in reality is in support of petitioner's contention herein that the technical characteristics which support the tax from a constitutional standpoint are not necessarily controlling in determining when a tax "accrues."

8. Respondent's Discussion of the "Dobson" Principle.

Petitioner believes that it is clear that the Tax Court erred. Further, this error is in its failure to apply the correct rule of law. It failed to determine the accrual in accordance with the express provisions of the Franchise Tax Act. It admittedly and deliberately disregarded the express provisions of the Act relating to the time "liability" arose and a lien therefor attached. It applied erroneous principles of law, and misinterpreted the principles established in the *Anderson* case and in the *Supplee* case relating to the time of accrual of liability for taxes. Clearly, the *Dobson*[6] principle has no application under such circumstances. (See Op. Br. 10-12.)

Nor do the cases cited by respondent support its ap-

[6]*Dobson v. Commissioner* (1943), 320 U. S. 489.

plication here. The *Security Flour Mills* case, *supra,* squarely holds, and the *Dixie Pine Co.* case, *supra,* recognizes, that if the Tax Court applies an *incorrect rule of law* in determining that an item is not deductible on the accrual basis, the decision is *not* entitled to the finality indicated by the *Dobson* case. In fact, in the *Security Mills* case both the Circuit Court of Appeals and the Supreme Court reached a different result from that reached by the Tax Court decision therein.

Nor does the doctrine in regard to deductions being a matter of grace, referred to by respondent (Br. 34), entitle the Tax Court to deny deductions according to erroneous principles. Here there is no question as to the right to a deduction. The only question is as to the proper year in which to take the deduction on the accrual basis.

The recent decisions of this court in *Seattle Brewing & Malting Co. v. Commissioner,* .... F. (2d) ...., and *Commissioner v. Rainier Brewing Co.,* .... F. (2d) ...., both decided on January 8, 1948 (see 1948 Prentice-Hall Federal Tax Service, Paragraphs 72,315 and 72--316), were clearly fact cases. This is emphasized by the opinions rendered in denying a rehearing, on February 18, 1948. (See 1948 P.H. Fed. Tax Serv., Paragraphs 72,-372 and 72,373.)

Another interesting fact in regard to these recent decisions by this Court is that they utilize exactly the same tests with respect to the applicability or inapplicability of the *Dobson* case, regardless of whether it is the taxpayer or the government that is seeking the review of the Tax Court decision. They thus provide a complete answer, if any be needed, to the Commissioner's implication (Br. 34) that although the *Dobson* principle must be applied against the taxpayer, it would not have been

available to support the decision if the Tax Court had held in favor of the taxpayer.

Finally, respondent's *Dobson* argument overlooks the fact that it was he who appealed from the decisions of the Tax Court in the *Security Mills* and *Le Roy*[6] cases. In the former case the Tax Court was reversed; in the latter it was affirmed.

Conclusion.

The petition for review should therefore be granted, and the decision of the Tax Court reversed and the case remanded to the Tax Court with instructions to enter judgment for the petitioner consistent with Section 322(d) of the Internal Revenue Code. See pages 7 and 8 of Petitioner's Opening Brief.

Respectfully submitted,

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Los Angeles, California, March 17, 1948.

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[6]*Commissioner v. Le Roy* (C. C. A. 2, 1945), 152 F. (2d) 936.